DOCUMENT RESUME

ED 393 374 HE 029 049

TITLE	Financial Audit. Federal Family Education Loan Program's Financial Statements for Fiscal Years 1994 and 1993. Report to the Congress.
INSTITUTION	Comptroller General of the U.S., Washington, D.C.
REPORT NO	GAO/AIMD-96-22
PUB DATE	26 Feb 96
NOTE	76p.
AVAILABLE FROM	U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20884-6015 (first copy free, additional copies $2 each).
PUB TYPE	Reports - Evaluative/Feasibility (142)
EDRS PRICE	MF01/PC04 Plus Postage.
DESCRIPTORS	Accountability; Computer System Design; Databases; Educational Finance; Federal Aid; *Financial Audits; Higher Education; Program Improvement; Student Financial Aid; Student Loan Programs
IDENTIFIERS	Department of Education; *Family Education Loan Program; Financial Reports; Guaranty Agencies

ABSTRACT

The United States General Accounting Office (GAO) reviewed the Department of Education's Office of Inspector General's (OIG) audit of the annual financial statements for the Federal Family Education Loan Program (FFELP) for the fiscal year ended September 30, 1994. GAO reviewed OIG's audit rather than conduct its own to avoid duplication and to reduce expense. The study reviewed OIG's method and planning, evaluated its audit staff, participated in tests of cash receipts and disbursements, and reviewed OIG's working papers and other statements. OIG concluded that: (1) FFELP's liabilities for loan guarantees and related program costs were primarily calculated using models based on student loan data found to be unreliable; (2) that the Department of Education did not have systems or procedures in place to ensure that individual billing reports submitted by guaranty agencies and lenders were reasonable; and (3) that the financial reporting process did not ensure reliable reports. Corrective actions that were in progress included implementation of a new national database of loan-level data, new audit standards for lenders, and redesign of current financial management systems into a newly integrated core financial system. Continued weaknesses were found in computer general controls over FFELP's information system. An appendix contains a complete copy of the OIG report. (JB)

United States General Accounting Office

GAO

Report to the Congress

February 1996

FINANCIAL AUDIT

Federal Family Education Loan Program's Financial Statements for Fiscal Years 1994 and 1993

GAO/AIMD-96-22

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-258863

February 26, 1996

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the result of our review of the Department of Education's Office of Inspector General's (OIG) financial audit of the Federal Family Education Loan Program's (FFELP) Principal Financial Statements and its internal controls and compliance with laws and regulations for the fiscal year ended September 30, 1994. We conducted our review pursuant to section 432(b) of the Higher Education Act of 1965, as amended (20 U.S.C. 1082(b)).

This is the third year the FFELP's Principal Financial Statements were prepared. The OIG was unable to express an opinion on the financial statements taken as a whole because student loan data on which Education based its costs to be incurred on outstanding guaranteed loans (referred to as liabilities for loan guarantees), was not reliable. In addition, the OIG continued to report material weaknesses in internal controls related to determining FFELP's liabilities for loan guarantees and related program costs, effectively monitoring payments to guaranty agencies and lenders, and ensuring accurate financial reporting. Although internal control weaknesses persisted during fiscal year 1994, Education has been working towards correcting these weaknesses. We reviewed the work of the OIG and concur with its reports.

We are sending copies of this report to the Secretary of Education, the Inspector General, and other Department officials. We are also sending copies to the Director of the Office of Management and Budget, the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight, and other interested congressional committees. Copies will be made available to others upon request.

This report was prepared under the direction of Lisa G. Jacobson, Director, Accounting and Information Management Division, who may be reached at (202) 512-9095.

for

Charles A. Bowsher
Comptroller General
of the United States

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Abbreviations

EDCAPS	Education's Central Automated Processing System
FFELP	Federal Family Education Loan Program
NSLDS	National Student Loan Data System
OIG	Office of Inspector General

GAO

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of the United States

B-258863

To the Secretary of Education

Legislation[1] requires the Department of Education to prepare annual financial statements for the Federal Family Education Loan Program (FFELP) and requires the Comptroller General and Education's Inspector General to audit these statements. Fiscal year 1994 was the third year that FFELP's Principal Financial Statements were prepared, and data reliability problems continued to preclude the auditors from rendering an opinion on three of the four statements. Although internal control weaknesses persisted during fiscal year 1994, Education has been working towards correcting these weaknesses.

Education's Office of Inspector General (OIG) was required to audit the FFELP Principal Financial Statements for the fiscal year ended September 30, 1994, and issued its report dated May 8, 1995.[2] (See appendix I.) For fiscal year 1993, we worked with the OIG in an effort to audit these statements and jointly issued a report dated May 20, 1994.[3] The joint report covering fiscal year 1993 did not include an opinion on the Statement of Financial Position, Statement of Operations and Changes in Net Position, and Statement of Budgetary Resources and Actual Expenses because the student loan data on which Education based its costs to be incurred on outstanding guaranteed loans (referred to as liabilities for loan guarantees) was not reliable. We were able to determine, through detailed audit procedures, that the fiscal year 1993 Statement of Cash Flows presented fairly the cash actually received and disbursed by FFELP. However, because of the material internal control weaknesses identified, we could not determine if the cash Education received or disbursed was all that it should have.

For fiscal year 1994, the OIG was unable to express an opinion on the financial statements taken as a whole because of the previously reported data reliability problems.[4] We concur with the OIG's disclaimer of opinion. Further, we also concur with the OIG that the fiscal year 1994 Statement of Cash Flows presents fairly, in all material respects, the cash actually

[1]Section 3515 and 3521 of title 31, United States Code, and section 432(b) of the Higher Education Act of 1965, as amended (20 U.S.C. 1082(b)).

[2]Financial Statement Audit: U.S. Department of Education Federal Family Education Loan Program for the Years Ended September 30, 1994 and 1993 (ACN 17-40302).

[3]Financial Audit: Federal Family Education Loan Program's Financial Statements for Fiscal Years 1993 and 1992 (GAO/AIMD-94-131, June 30, 1994).

[4]See footnote 3 and Financial Audit: Federal Family Education Loan Program's Financial Statements for Fiscal Year 1992 (GAO/AIMD-93-4, June 30, 1993).

received and disbursed by FFELP. However, because of the material internal control weaknesses identified, the OIG could not determine if the cash Education received or disbursed was all that it should have.

For fiscal year 1994, the OIG reported that material weaknesses in FFELP's internal control structure existed. These material weaknesses, which were previously reported, relate to determining FFELP's liabilities for loan guarantees and related program costs, effectively monitoring payments to guaranty agencies and lenders, and ensuring accurate financial reporting.[5] We concur with the OIG's findings. As part of a financial audit, the OIG is not required to and therefore did not express an opinion on internal controls. However, the above material weaknesses resulted in ineffective controls over safeguarding assets and assuring that there were no material misstatements in FFELP's Principal Financial Statements.

The OIG also reported that improvements in Education's policies and procedures related to cash reconciliations, loan receivables, and controls over an information subsystem were needed. We agree with the OIG's assessment and related recommendations in these areas.

Further, we concur with the OIG that with respect to the items tested, FFELP complied in all material respects with the provisions of laws and regulations tested. However, since such tests were limited to selected provisions of laws and regulations, this conclusion does not represent an overall opinion on compliance with laws and regulations for fiscal year 1994.

For fiscal year 1994, the OIG also reviewed the financial information in management's Overview of the Reporting Entity and did not report any material inconsistencies with the Principal Financial Statements. However, as noted by the OIG, this information was generally derived from the same sources as the information presented in the Principal Financial Statements. Consequently, we believe that because of ineffective internal controls and unreliable student loan data, the reliability of information presented in the Overview of the Reporting Entity cannot be reasonably determined.

Background

FFELP, established in 1965 and formerly known as the Guaranteed Student Loan Program, is the largest postsecondary education loan program of the federal government. Its primary mission is to increase postsecondary

[5]See footnote 4.

education opportunities for eligible students who otherwise may not be able to further their education. As of September 30, 1994, Education reported an estimated $77 billion in outstanding loan guarantees, about $23 billion of which was guaranteed in fiscal year 1994 alone.

Objectives, Scope, and Methodology

To meet our audit responsibility and to avoid duplication and unnecessary expense, we reviewed the OIG's work. To determine the reasonableness of the OIG's work and the extent to which we could rely on it, we

- reviewed the OIG's audit methodology and planning;
- evaluated the qualifications and independence of the OIG's audit staff;
- participated in tests of cash receipts and disbursements;
- reviewed the OIG's working papers to determine compliance with generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 93-06 "Audit Requirements for Federal Financial Statements," including assessing the appropriateness of (1) the nature, timing, and extent of substantive tests performed, (2) the evaluation of the entity's internal controls, and (3) the testing of compliance with significant provisions of selected laws and regulations; and
- read the financial statements and the OIG's May 8, 1995, report to evaluate conformity with (1) the other comprehensive basis of accounting stated in note 2 and (2) OMB Bulletin 94-01, "Form and Content of Agency Financial Statements."

Our work was conducted from October 1994 through June 1995 in accordance with generally accepted government auditing standards.

Internal Control Weaknesses Persist but Some Corrective Actions Are in Progress

Consistent with prior GAO and OIG reports, the OIG concluded that

- FFELP's liabilities for loan guarantees and related program costs were primarily calculated using models which continued to be based on student loan data found to be unreliable;
- Education did not have systems or procedures in place during fiscal year 1994 to ensure that individual billing reports submitted by guaranty agencies and lenders were reasonable; and
- the financial reporting process[6] did not ensure that financial statements and other management reports were reliable.

[6]The financial reporting process includes analyzing, evaluating, summarizing, reconciling, adjusting, and reclassifying information so that it may be reported to management and/or outsiders. Accounting and information systems supporting FFELP are an integral part of this process.

Education has made some progress in addressing these issues. It has begun implementing the National Student Loan Data System (NSLDS)—the first national database of loan-level data. According to the OIG, although NSLDS was not designed as a financial system, it could provide valuable information on characteristics of Education's loan portfolio that would be useful in estimating program costs. However, as noted by the OIG, the usefulness of this data depends on its accuracy and validity. As a result, we agree with the OIG's recommendation that Education needs to test the accuracy and validity of the loan data in NSLDS. Education is currently working with a contractor to identify and verify critical data items in NSLDS.

In March 1995, the OIG issued an audit guide requiring all lenders participating in FFELP to have an annual compliance audit by a nonfederal auditor. The purpose of these audits is to obtain auditor attestations regarding lenders' assertions that their respective requests for payment of interest and special allowances are accurate, complete, properly classified and computed, and supported by adequate loan documents. Education will need to monitor implementation of the audit guide requirements to ensure that it receives those assurances regarding the accuracy of lenders' billings.

Education is redesigning its current financial management systems into a newly integrated core financial system called Education's Central Automated Processing System (EDCAPS). The Financial Management Systems Software module within EDCAPS will replace the current antiquated and inefficient general ledger system and is expected to directly produce the FFELP financial statements. This module is expected to be implemented in fiscal year 1997.

In addition, Education has initiated a task order with the FFELP information system contractor to develop permanent subsidiary ledgers supporting general ledger balances and to improve the interface between the FFELP subsidiary systems and the general ledger system. As reported by the OIG, one of the primary purposes of these improvements is to provide a detailed audit trail for all transactions posted from the subsidiary systems to the general ledger system. If successful, these initiatives should assist Education in addressing identified financial reporting problems.

We have separately reported on Education's computer general controls over FFELP's information system. We continued to find weaknesses in that system's ability to adequately protect sensitive data files, applications programs, and systems software from unauthorized use.[7] Effective computer general controls over FFELP's information system are critical to safeguarding assets, maintaining sensitive student loan data, and ensuring the reliability of financial management information. Education reported that it has acted to correct the weaknesses identified, such as implementing new security oversight procedures and working with the information system contractor to remedy access and software control problems. Future audits should determine the effectiveness of these and other corrective actions.

Status of Previous Recommendations

Education has made some progress in addressing prior years' recommendations. Of the 21 recommendations made during the past 2 years, 8 have been closed and action was in progress or planned for 11. Of the remaining 2, one requires congressional action and no specific action was planned for the other.[8] Until corrective action is completed on all prior year recommendations, we continue to reaffirm open recommendations included in the OIG's report on FFELP's Principal Financial Statements for fiscal years 1994 and 1993. (These prior years' recommendations are reprinted on pp. 65 and 66 of this report.)

Agency Comments

Officials in Education's Office of the Chief Financial Officer and Office of Postsecondary Education reviewed a draft of this report and generally concurred with the conclusions. Their comments have been incorporated where appropriate. Consistent with their comment on the OIG's report, Education officials disagreed with the conclusion that unreliable loan data prevents them from reasonably estimating FFELP liability costs. They believe that the estimates of liabilities for loan guarantees and subsidy expenses are reasonable because prior years' estimates were consistent with actual cash flows. However, we agree with the OIG that there was insufficient reliable audit evidence to support management's estimate.

[7]Federal Family Education Loan Information System: Weak Computer Controls Increase Risk of Unauthorized Access to Sensitive Data (GAO/AIMD-95-117, June 12, 1995).

[8]No action was planned for the study of the feasibility of requiring guaranty agencies to standardize their FFELP loan accounting systems because Education believes that the role of the guaranty agencies is expected to be significantly phased down as a result of the Federal Direct Student Loan Program.

Education officials advised us that they are developing a methodology they believe will produce auditable and verifiable estimates of liabilities for loan guarantees and subsidy expenses.

Charles A. Bowsher
Comptroller General
of the United States

June 30, 1995

Education's OIG Report on FFELP Financial Statements for Fiscal Year 1994

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

May 31, 1995

Honorable Richard W. Riley
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

This report presents the results of our audit of the Department of Education's Federal Family Education Loan Program (FFELP) principal financial statements for the fiscal years ended September 30, 1994 and 1993. This audit was required under the Chief Financial Officers Act of 1990.

The results of the audit were discussed with members of your staff throughout the audit. The Offices of the Chief Financial Officer and Postsecondary Education responded to the findings and recommendations presented in the draft audit report. Based on the response, management is in general agreement with the recommendations in the report. Management disagrees with our conclusion that unreliable loan data prevents the Department from reasonably estimating liability costs. The complete text of the combined response and our comments to it are included in Appendix II.

During the course of our audit, we identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us in the audit.

Steven A. McNamara
Steven A. McNamara
Assistant Inspector General
for Audit

Enclosure

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HIGHLIGHTS OF RESULTS

Requirement

In accordance with the Chief Financial Officers Act of 1990, we were required to audit the accompanying principal financial statements of the United States Department of Education's Federal Family Education Loan Program (FFELP) for the fiscal years ended September 30, 1994 and 1993. Last year, the General Accounting Office and the Office of Inspector General jointly performed the audit of the fiscal year 1993 financial statements.

Inspector General's Report on Financial Statements

The FFELP's liabilities for loan guarantees as of September 30, 1994 and 1993 were primarily calculated using models which were based upon unreliable student loan data. Because we were unable to perform procedures to satisfy ourselves as to the valuation of these liabilities and the related subsidy costs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the principal financial statements taken as a whole.

We determined, through detailed procedures, that the statements of cash flows for the fiscal years ending September 30, 1994 and 1993, state fairly the cash actually received and disbursed by FFELP, in conformity with the basis of accounting described in Note 2. Because of material internal control weaknesses, however, we were unable to determine if the Department received or disbursed the proper amounts.

Inspector General's Report on Internal Controls

In planning and performing the audit of the principal financial statements of FFELP for the fiscal year ended September 30, 1994, we considered its internal control structure in order to determine the auditing procedures for the purpose of expressing an opinion on the principal financial statements and not to provide assurance on the internal control structure.

The report on internal control structure disclosed conditions existing during fiscal year 1994 which we considered to be material weaknesses. These are the same material weaknesses reported as part of the 1993 and 1992 financial audits. Corrective actions completed and outstanding from previous financial audits are indicated in Appendix I.

1

Unreliable Loan Data

FFELP's estimated liabilities for loan guarantees and related program costs continue to be based on unreliable historical loan data.

Verification of Billings

Improvements are necessary to ensure billings from lenders and guaranty agencies are reasonable. Lender and guaranty agency billings have not been adequately verified for accuracy and completeness.

Financial Reporting Process Capability

Improvements are necessary to enhance the Department's financial management process to ensure that the financial statements and other management reports are reliable. Previously reported problems still exist with the Department's general ledger, FFELP's subsidiary ledgers and in FFELP's operation of the general controls over the information and accounting systems. We also noted two additional areas, cash reconciliations and loans receivable, where the Department could make improvements to financial management policies and procedures.

Our recommendations to address these weaknesses are provided on page 14. The Department has already put forth substantial efforts and made progress in correcting these problem areas and we encourage their continued efforts until the recommendations are fully implemented.

Inspector General's Report on Compliance with Laws and Regulations

FFELP complied, in all material respects, with provisions of laws and regulations which we tested. With respect to items not tested, nothing came to our attention that caused us to believe that FFELP had not complied, in all material respects, with those provisions.

Department's Comments and OIG Response

Management is in general agreement with the recommendations in the report. Management disagrees with our conclusion that unreliable loan data prevents the Department from estimating liability costs. The complete text of the Department's comments and our response is included in Appendix II.

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UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

INSPECTOR GENERAL'S REPORT ON FINANCIAL STATEMENTS

To the Secretary of Education

Requirement

In accordance with the Chief Financial Officers Act of 1990, we were required to audit the accompanying statements of financial position of the United States Department of Education Federal Family Education Loan Program (FFELP), as of September 30, 1994 and 1993, and the related statements of operations and changes in net position, cash flows, and budgetary resources and actual expenses for the years then ended. These principal financial statements are the responsibility of the United States Department of Education management.

Accounting Policies

As explained more fully in Note 2, "Summary of Significant Accounting Policies," these financial statements were prepared in accordance with the form and content requirements specified in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*. Financial statements presented in this format are prepared on a comprehensive basis of accounting other than generally accepted accounting principles.

Unreliable Loan Data

The costs to be incurred on outstanding guaranteed loans (referred to as liabilities for loan guarantees) were primarily calculated using models which were based upon unreliable student loan data. Due to the number of entities involved in providing this data and the range of errors found in previous audits,[1] we could not practically determine the potential magnitude of such errors and their effect on the FFELP's liabilities for loan guarantees as of September 30, 1994 and 1993. Other relevant evidence to support a conclusion about the fair presentation of FFELP's liabilities for loan guarantees, and their related subsidy costs, was either not reliable or not considered sufficient. This condition is essentially unchanged from previous years' audits.

[1]FINANCIAL AUDIT: Federal Family Education Loan Program's Financial Statements for Fiscal Year 1992 (GAO/AIMD-93-04, June 30, 1993), 7.

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These liabilities are the most significant amounts in the accompanying financial statements, and are reported at $15.2 billion and $13.6 billion, as of September 30, 1994, and 1993, respectively.

Disclaimer

Since the liabilities for loan guarantees were based upon unreliable data and we were unable to perform other procedures to satisfy ourselves as to the valuation of these liabilities and the related subsidy costs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements taken as a whole.

We determined, through detailed procedures, that the statements of cash flows for the fiscal years ending September 30, 1994 and 1993, state fairly the cash actually received and disbursed by FFELP, in conformity with the basis of accounting described in Note 2. Because of material internal control weaknesses, however, we were unable to determine if the Department received or disbursed the proper amounts.

We have reviewed the financial information in management's overview of the reporting entity for any material inconsistencies with the principal financial statements. Such information has not been audited by us and, accordingly, we do not express an opinion on this information.

Steven A. McNamara

Steven A. McNamara
Assistant Inspector General
for Audit

May 8, 1995

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UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

INSPECTOR GENERAL'S REPORT ON INTERNAL CONTROL STRUCTURE

To the Secretary of Education

Requirements

We were required to audit the principal financial statements of the Federal Family Education Loan Program (FFELP) of the United States Department of Education (the Department), as of and for the years ended September 30, 1994 and 1993, and have issued our report thereon dated May 8, 1995.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal financial statements are free of material misstatement.

In planning and performing our audit of the principal financial statements of FFELP for the years ended September 30, 1994 and 1993, we considered the FFELP internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the principal financial statements and not to provide assurance on the internal control structure. With respect to those controls that are material to the financial statements, we determined whether FFELP has an internal control structure that provides reasonable assurance of achieving the internal control objectives.

Management's Responsibility for Internal Controls

The Department's management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets; (2) funds, property, and other assets are safeguarded against loss from unauthorized use

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or disposition; and (3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Control Structure Categories

For the purpose of this report, we have classified the FFELP significant internal control structure policies and procedures in the following categories:

- Treasury
- Budget
- Financial Reporting

For the internal control structure categories previously listed, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk. The information reported in management's overview of the reporting entity was generally derived from the same sources as the information presented in the principal statements. Consequently, the policies and procedures referred to above are also relevant to the information in the overview of the reporting entity.

Scope of Internal Control Work

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses, as defined below. For this reason, we do not express an opinion on the FFELP internal control structure, taken as a whole, or within the categories listed above. However, we noted certain matters involving the internal control structure and its operation that we consider to be material weaknesses under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06.

Material weaknesses are matters coming to our attention relating to significant deficiencies in the design or operation of one or more of the internal control structure elements that in our judgement do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Material Weaknesses Identified

We noted three matters involving the internal control structure and its operation that in our opinion continue to represent material weaknesses during fiscal year 1994. These are the same material weaknesses reported by GAO in their internal controls report issued in conjunction with their audit of the fiscal year 1992 FFELP financial statements,[2] and jointly reported by GAO and OIG in the audit of the fiscal year 1993 FFELP financial statements.[3] They are as follows:

- Unreliable loan data continues to prevent the Department from reasonably estimating FFELP costs;

- Controls are not in place to verify billing reports submitted by guaranty agencies and lenders are reasonable; and

- The financial reporting process does not ensure that financial statements and other management reports are reliable.

Corrective actions are in progress or complete for all of the recommendations from the fiscal years 1992 and 1993 FFELP financial audits, as shown in Appendix I.

Unreliable Loan Data Continues to Prevent the Department from Reasonably Estimating FFELP Costs

FFELP's liabilities for loan guarantees and related program costs were primarily calculated using models which continue to be based on student loan data found to be unreliable in previous audits. Due to the number of entities involved in providing this data and the range of errors found, it was not practical to determine the potential magnitude of such errors, nor their effect on the FFELP's liabilities for loan guarantees as

[2]FINANCIAL AUDIT: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, March 16, 1993).

[3]FINANCIAL AUDIT: Federal Family Education Loan Program's Financial Statements for Fiscal Years 1993 and 1992(GAO/AIMD-94-131 and ACN 17-30302, June 30, 1994).

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of September 30, 1994, and on program costs submitted in the annual budget process.

The Department relies on participating schools, lenders, servicers and guaranty agencies to deliver the program and make available to the Department the information necessary to account for the FFELP. This complexity of the program structure hampers the Department's ability to obtain reliable student loan data. For example, the Department implemented a major data gathering and analysis initiative with the approval of OMB, to estimate and reestimate costs of loan guarantees using a random sample of guaranteed loans in the FFELP portfolio. However, three of the largest guaranty agencies, from which the Department had planned to obtain more than half of the sample records, did not provide these records. Subsequent attempts to obtain them were not successful. Therefore, the Department was prevented from obtaining the required information to estimate and reestimate program costs in the manner agreed to by OMB.

Cash Flow Analysis

In an effort to substantiate the estimated liabilities for loan guarantees, the Department compared three years of FFELP cash receipts and disbursements to projections of the models. While this cash flow analysis may have some merit, we do not believe it currently provides sufficient evidence to substantiate the most material line items on the financial statements, nor does it demonstrate there is a correlation between the estimated liabilities and the cash flows. In addition, we were unable to determine if the cash received and disbursed were the proper amounts.

National Student Loan Data System

The Department is continuing to implement the National Student Loan Data System (NSLDS) to obtain loan-by-loan information on all loans to borrowers under the Higher Education Act of 1965. Although not designed as a financial system, NSLDS could still provide valuable information on the characteristics of the Department's portfolio, and thus be useful in estimating costs of the programs. We and the Department recognize NSLDS could be useful in this manner only if the data captured is reliable. The Department has already worked more closely with the guaranty agencies in trying to understand and resolve some of the student loan data errors and to implement better edit checks in the system. While these checks may screen out obvious errors and inconsistencies, they do not ensure that the remaining data is valid and accurate.

Controls are not in Place to Verify Billing Reports Submitted by Guaranty Agencies and Lenders are Reasonable

The Department did not have systems or procedures in place during fiscal 1994 to ensure that individual billing reports submitted by guaranty agencies and lenders were reasonable. In order to ensure that accurate payments are made for defaults, interest subsidies, and special allowances, the Department needs to know that billing reports from the guaranty agencies and lenders are accurate and valid.

Guaranty agencies' and lenders' external audits are broad in scope and auditors are not required to, and therefore do not conduct, in-depth examinations of the accuracy and validity of guaranty agencies' and lenders' claims for defaulted loans and interest subsidies. These audits generally do not provide assurance to the Department as to the accuracy of the claims submitted or to the adequacy of guaranty agencies' and lenders' internal controls over such claims.

In response to a prior audit recommendation, the Department issued an audit guide in March 1995 requiring all lenders participating in the FFELP Program to have an annual compliance audit performed by a non-Federal auditor. These audits will test a lender's compliance with certain management assertions made in the lender's requests for payment of interest and special allowance (Form 799). The assertions to be tested include that the information reported on the Form 799 is accurate, complete, properly classified and computed, and supported by adequate loan documents. Action is also in progress on preparing an audit guide for tests of guaranty agency billings.

The Financial Reporting Process Does Not Ensure That Financial Statements and Other Management Reports are Reliable

Although the Office of Chief Financial Officer (OCFO) and the Office of Postsecondary Education (OPE) have taken significant steps to address longstanding problems with financial management, material weaknesses in the financial reporting process still exist. Weaknesses concerning the general ledger, subsidiary ledgers and general controls over information and accounting systems were identified in previous audits. We also noted two additional areas, cash reconciliations and loans receivable, where the Department could make improvements to financial management policies and procedures.

General Ledger and Subsidiary Systems Do Not Support Auditable Financial Statements

The Department is taking steps to address weaknesses in the general ledger and subsidiary systems which have been reported in previous years. These steps include the development of Education's Central Automated Processing System (EDCAPS) which will replace the current antiquated and inefficient Primary Accounting System. Among EDCAPS' expected capabilities is the automated processing of the general ledger and financial statements. We were informed that EDCAPS is scheduled for implementation in 1997.

The Department has also initiated a task order with the FFELP contractor to develop permanent subledgers supporting general ledger balances and make improvements to the interface between the FFELP subsidiary systems and the new EDCAPS. One of the primary purposes of these improvements is to provide a detailed audit trail for all transactions posted from the subsidiary systems to the general ledger system.

While the Department is taking significant action to improve financial management in the future, the following problems previously reported still existed during fiscal year 1994:

- The general ledger system was unable to directly produce the FFELP financial statements because it was outdated and was designed primarily for funds control; and
- Permanent subsidiary ledgers supporting general ledger balances were not established and maintained.

Improvements Needed to General Controls Over Information and Accounting Systems

In our fiscal year 1993 financial statement audit, we reported that the Department's general controls over information and accounting systems were not functioning as designed.
The status of our recommendations concerning general control weaknesses over accounting systems is included in Appendix I. During fiscal year 1994, the General Accounting Office (GAO) tested the general controls over FFELP's information systems. GAO found that the Department and its contractor, who maintains and operates FFELP's information system, have improved some of the general control weaknesses identified in the prior financial audit reports. For example, important computer system duties have been appropriately segregated and disaster recovery plans were tested.

However, the FFELP information system's general controls do not adequately protect sensitive data files, applications programs, and systems software from unauthorized access. Significant weaknesses remain in controlling system access and making software changes. The Department, for example, did not (1) adequately monitor the access activities of system users having special privileges allowing them to independently change the system or (2) record, report, and review successful access to sensitive computer data and programs.

The FFELP information system's serious access and software change control deficiencies resulted in part because the Department had not developed adequate policies and procedures in key control areas or implemented a means to ensure the contractor maintains adequate general controls. While a contractor operates and maintains the FFELP information system, the Department is responsible for establishing appropriate computer security policies and procedures and overseeing the contractor's compliance with them.

To address these general control weaknesses, the Department informed GAO that (1) in early 1995, the system's contractor made access control improvements and (2) during fiscal year 1995, management plans to implement additional corrective actions, such as performing periodic reviews of sensitive data files to ensure that inappropriate changes have not been made. GAO plans to separately report in more detail on these matters and will provide the Department with recommendations for corrective action.

Additionally, we reviewed selected controls over the Guaranty Agency Fund subsystem and identified several needed improvements. We found that systems documentation was outdated and did not reflect current operations. Specifically, we were informed that many of the programs producing management reports were not currently used because of conflicting data elements resulting when the system was transferred to the current contractor in 1992. Management is aware of this problem and a task order is underway to address it.

We also found that the Guaranty Agency Fund subsystem has a global edit override capability allowing authorized personnel to turn off all edit routines on processing of reinsurance requests from guaranty agencies. Currently, there is no audit trail to determine which reinsurance requests were processed with the global edit override in effect. Therefore, there is a risk that reinsurance payments have been made without being subjected to normal editing routines. Although the risk of error is mitigated by the Department's manual review of the subsystem output, the Department should limit the use of this global edit override process and actively track its use.

Improvements Needed on Cash Reconciliation Procedures

In order to comply with the requirements of the CFO Act, the Department performed a complete and well documented FFELP cash reconciliation for fiscal year-end. However, complete reconciliations, where reconciling items are allocated to the balances reported by the Department's general ledger and Treasury, are not being completed during the fiscal year. The result is the possible misstatement of fund balance with Treasury in the general ledger during the year. In order to ensure that the Department's fund balance with Treasury is fairly stated and safeguarded from unauthorized use and disposition, periodic reconciliations with Treasury's balances should be performed.

The Department's cash reconciliation procedures include a complex and time consuming process for matching and resolving reconciling items. The monthly process primarily consists of a computerized software program (the Automated Reconciliation Program), which identifies numerous reconciling items between cash transactions in the Department's disbursements and collections register and amounts reported to Treasury on Form 224. Additionally, the reconciliation process currently must identify reconciling differences within the Department's own general ledger and disbursements and collections register which must be researched.

Although the software program is run on a monthly basis, large reconciling items, including timing differences, are not being resolved on a timely basis. Summary documentation is not prepared for resolved and unresolved items and the proper adjusted monthly fund balance is not being determined.

Furthermore, we found that detailed cash reconciliation working papers were not independently reviewed and approved. Due to the large balances and volume of cash activity associated with the FFELP, we believe that the cash reconciliations performed should be independently reviewed and approved by either a supervisor or another employee not having direct responsibility for the cash reconciliation.

We were informed that the Department is attempting to modify the software program to reduce the manual matching that is currently necessary. If successful, this improvement should decrease the time necessary to complete reconciliations.

Department Needs to Implement New Loans Receivable Accounting Requirements

The Department's current policies and procedures do not adequately address requirements of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards Number 2 *Accounting for Direct Loans and Loan Guarantees* (FASAB 2). FASAB 2 states that when a federal guarantor acquires loans as compensation for losses sustained on post-1991 loan guarantees, the acquired loans are recognized at the present value of their estimated net cash inflows. For FFELP, these cash inflows are the estimated collections from the borrowers. FASAB 2 requires that the net present value calculation should use the original discount rate (interest rate) established by Treasury in the year the loans were originally guaranteed.

The Department's current system does not allow it to readily comply with the new FASAB 2 requirements. Specifically, the following factors, resulting from the structure of the FFELP, prevent the Department from properly reporting on loans receivable acquired from post-1991 loans.

- A large portion of the gross loans receivable is maintained at guaranty agencies who attempt collection on the Department's behalf. The Department receives only summary data regarding receivable activity and does not have ready access to individual loan detail.

- The Department is currently unable to segregate guaranteed loan activity by year of guarantee. This prevents the Department from identifying loans receivable acquired from post-1991 guarantees. These are the loans required to be reported at net present value under FASAB 2.

- The inability to segregate activity by year of guarantee also prevents the Department from properly calculating

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net present value using the original discount rate determined during the year of guarantee.

In past years, the Department reported loans receivable with a 100 percent allowance. Actual collections were accounted for by adjusting the subsidy costs and the liability estimate. The Department adopted a policy in fiscal year 1994 which requires that loans receivable acquired subsequent to September 30, 1992 be reported net of an allowance for uncollectible defaulted loans. While this policy is a step in the right direction, it does not meet FASAB 2's requirement for valuation at net present value. Additionally, the Department does not have procedures in place to segregate future collections relating to loans carried under the new policy.

The Department is aware of the limitations in its policies and is working to find solutions. Since FASAB 2 requirements only relate to post-1991 guarantees, we do not believe that the value of loans receivable related to these guarantees would be material for fiscal year 1994. However, it is imperative that the Department modify its policies and procedures to address this issue as the number of defaults on post-1991 guarantees begins to rise in the next few years.

Recommendations

The status of recommendations from prior years' financial audits is presented in Appendix I. We also provide the following additional recommendations.

1. We recommend that the Department review and amend its cash reconciliation policies and procedures to make reconciliations more timely and effective. In performing this review, the Department should:

   - continue planned improvements which will enhance the reconciliation software program by directly loading general ledger information;

   - require timely posting of adjustments to the general ledger and Treasury Form 224;

   - investigate the primary causes of recurring reconciliation problems and build controls into the

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subsidiary systems to prevent future occurrences; and

- consider reconciliation needs during development of EDCAPS to eliminate the need to run the current software program and more fully automate the reconciliation process.

2. We recommend that periodic fund balance reconciliations be independently reviewed by either a supervisor or another employee not having direct responsibility for the reconciliation. The reviewer should document the review by initialling and dating the reconciliation.

3. We recommend that the Department modify its policies and procedures to properly account for loans receivable under the FASAB 2 requirements. In developing these policies and procedures, we suggest that the Department:

   - take advantage of new reinsurance reporting requirements which require guaranty agencies to segregate default and collection information by loans guaranteed prior to FY 1993 and loans guaranteed in FY 1993 and after;

   - explore the capability of producing management reports from the new NSLDS which could segregate loans receivable reported by guaranty agencies by year of guarantee; and

   - recalculate the allowance for subsidy on a quarterly basis based on outstanding loans receivable identified through management reports.

4. We recommend that the Department test the accuracy and validity of the loan data in the NSLDS as a part of its routine guaranty agency oversight function.

5. We recommend that the Department develop and monitor an automated audit trail of the Guaranty Agency Fund subsystem global edit override process.

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Department's Response to Recommendations

The Department's comments on our draft report are included in Appendix II. Management stated that it was in general agreement with the recommendations in the report. Management plans to analyze the specific recommendations and develop a comprehensive corrective action plan.

Other Matters

During the course of our audit, we identified other matters involving the internal control structure and its operation which do not affect the fair presentation of the FFELP financial statements. These matters nonetheless warrant management's attention and will be reported separately in a management letter.

Steven A. McNamara

Steven A. McNamara
Assistant Inspector General
for Audit

May 8, 1995

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UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

INSPECTOR GENERAL'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

To the Secretary of Education

Requirement

We were required to audit the principal financial statements of the Federal Family Education Loan Program (FFELP) of the United States Department of Education (the Department), as of and for the years ended September 30, 1994 and 1993, and have issued our report thereon dated May 8, 1995.

Standards

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal financial statements are free of material misstatement.

Laws and Regulations

Compliance with laws and regulations applicable to FFELP is the responsibility of the Department's management. As part of obtaining reasonable assurance about whether the principal financial statements are free of material misstatement, we tested compliance with laws and regulations that directly affect the financial statements and certain other laws, regulations, circulars and bulletins designated by OMB and the Department. We considered the following:

- Part B of Title IV of the Higher Education Act of 1965, as amended (20 U.S.C. 1071-1087.2);
- Federal Credit Reform Act of 1990 (Public Law 101-508);
- Chief Financial Officers Act of 1990 (Public Law 101-576);
- Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255);
- 34 Code of Federal Regulations, Part 682;
- OMB Bulletin 94-01, "Form and Content of Agency Financial Statements;" and
- OMB Bulletin 93-18, "Audited Financial Statements."

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As part of our audit, we also obtained an understanding of the process by which FFELP identifies and evaluates weaknesses required to be reported under the Federal Managers' Financial Integrity Act. We also assessed whether the information and manner of its presentation in management's overview of the reporting entity is materially inconsistent with the information in the principal financial statements included in the September 30, 1994 and 1993 annual financial statements. However, the objective of our audit of the principal financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Results

The results of our tests indicate that, with respect to the items tested, FFELP complied in all material respects with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that FFELP had not complied, in all material respects, with those provisions.

Steven A. McNamara

Steven A. McNamara
Assistant Inspector General
for Audit

May 8, 1995

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OVERVIEW OF REPORTING ENTITY

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OVERVIEW OF REPORTING ENTITY

I. BACKGROUND AND MISSION STATEMENT OF THE DEPARTMENT OF EDUCATION'S FEDERAL FAMILY EDUCATION LOAN PROGRAM

The Federal Family Education Loan (FFEL) Program, formerly called the Guaranteed Student Loan Program (GSLP) is the largest provider of financial aid among the Student Financial Assistance Programs administered within the U. S. Department of Education (the Department). The Student Financial Assistance Programs were authorized by Title IV of the Higher Education Act of 1965, providing funds to help students meet postsecondary education costs. The table below shows trends in Title IV aid over a 10-year period. In order to adjust for the effects of inflation, all comparisons are made using constant 1993 dollars.

TITLE IV AID AWARDED TO POSTSECONDARY STUDENTS IN CONSTANT 1993 DOLLARS (IN MILLIONS) SELECTED YEARS

Title IV Programs -- Constant 1993 Dollars (in millions)

Academic Years	FFELP	Pell	Perkins	CWS	SEOG	SSIG	Total
1984-85	$ 11,732	$ 4,134	$ 923	$ 879	$ 509	$ 104	$ 18,281
1987-88	14,165	4,648	1,002	790	521	94	21,220
1990-91	13,622	5,279	936	783	487	63	21,170
1993-94	20,838	5,590	915	748	544	71	28,706

FFELP	=	Federal Family Education Loan Program (formerly Guaranteed Student Loan Program)
Pell	=	Pell Grant Program
Perkins	=	Perkins Loan Program
CWS	=	College Work Study
SEOG	=	Supplemental Education Opportunity Grant
SSIG	=	State Student Incentive Grant

Source: All data was obtained from The College Board, Trends in Student Aid: 1984 to 1994, September 1994, p. 5.

Note: The Consumer Price Index for all urban dwellers (CPI-U) was used to adjust for inflation. Aid is reported by the academic year in which it was awarded. FFEL Program dollar volume represents loan commitments rather than actual amounts loaned. SSIG figures include only the federal portion.

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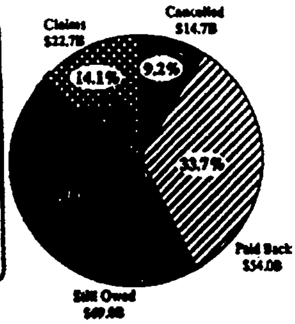
This program, which operates through state and nonprofit guaranty agencies, makes low-interest, long-term loans available to students attending participating postsecondary schools. Generally, these loans are made by commercial lenders, but some guaranty agencies and schools also participate participate as lenders in the program. Over $160 billion and $180 billion in loans have been guaranteed as of September 30, 1993 (see Figure 1), and September 30, 1994, respectively. Further, the outstanding balance of loans was about $77 billion at September 30, 1994.

Figure 1

FFEL PROGRAM PORTFOLIO STATUS AS OF 9/30/93

STAFFORD, PLUS, SLS and FISL loans guaranteed (commitments)	($ IN BILLIONS) 160.080
(-) Loans cancelled	14.721
(=) Net loans guaranteed	145.359
(+) HPSL/Perkins loans becoming FFEL's due to consolidation	.319
(=) Total net loans guaranteed	145.678
(-) Defaults	21.534
(-) Death, Disability and Bankruptcy	1.215
(-) Paid in fulls	22.124
(-) Installment payments	31.8[illegible]
(=) Current principal balance outstanding	69.000
A. Still in school	22.200
B. Current principal balance in repayment	46.800



Prepared by: U.S. Department of Education, OPE/SFAP/PTAS, Analysis and Forecasting Division, Loans Branch

The FFEL Program is comprised of the following five component loan programs: 1) Federal Stafford Loans; 2) Unsubsidized Federal Stafford Loans; 3) Federal Parent Loans for Undergraduate Students (PLUS), 4) Federal Supplemental Loans to Students (SLS), (discontinued July 1, 1994); and 5) Federal Consolidated Loans. These components are generally considered to be separate program entities because each has its own participants, loan limits and loan volume. However, students may participate in more than one program.

In the 29 years since the FFEL Program's inception in 1965, the student loan program has undergone numerous changes. Some of the most significant changes included requiring all loan applicants to demonstrate need in order to qualify for a federally subsidized loan (formerly only those with adjusted gross incomes of $30,000 a year or higher were subject to need analysis); increasing annual and aggregate loan limits for all borrowers; providing for unsubsidized Stafford loans for borrowers who do not qualify for federal interest subsidies under the Stafford Program; and implementing the William D. Ford Federal Direct Loan Program (Direct Loans).

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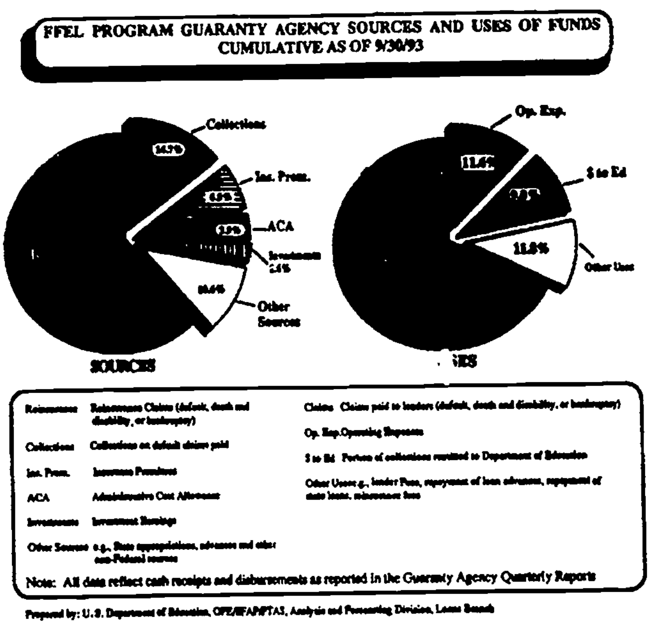
Mission and Goals

The FFEL Program was designed to increase postsecondary education opportunities for eligible students who otherwise may not have been able to further their education. The program operates on the premise that once educated, the borrowers earn income sufficient to repay their loans and also become more productive citizens than would otherwise be possible. In 1993 and 1994, the program generated about 5.6 million and 6.7 million new loans, respectively, totaling over $17.9 billion and $23.1 billion, respectively, for students attending over 6,500 schools. These loans were provided by approximately 7,500 lenders and administered by 45 state or nonprofit guaranty agencies participating in the program. The FFEL Program's mission is highly dependent upon guaranty agencies. As can be seen in Figure 2, about 90 percent of the guaranty agencies' revenues are received from the federal government.

Figure 2



Administering the FFEL Program supports two key Departmental priorities, which are: 1) to ensure access to a high quality postsecondary education and lifelong learning, and 2) to transform the Department into a high performance organization. The two key FFEL Program goals supporting these priorities are: 1) continuing to administer the program with integrity, equity and efficiency, while continuously improving the quality of service through strategies identified in the strategic plan; and 2) fostering and promoting an organizational culture supportive of responsive public service, diversity, innovation and continuous improvement.

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II. FINANCIAL RESULTS AND CONDITION

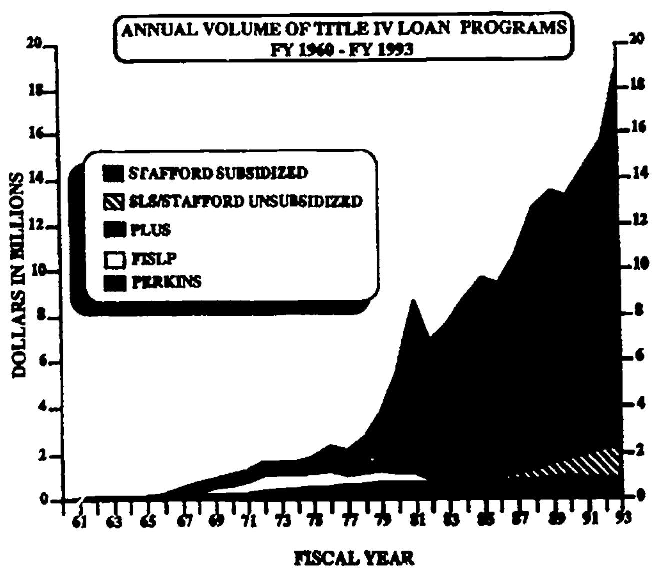
Fund Balances with the U.S. Treasury increased from $5.3 billion in fiscal year 1993 to $6.8 billion in fiscal year 1994. This increase is primarily attributable to the increase in loan volume during fiscal year 1994. Total liabilities increased from $16.5 billion to $16.8 billion due to increased loan volume, offset by repayment on borrowing from the U.S. Treasury.

Subsidy Expense increased from $2.7 billion in fiscal year 1993 to $3.3 billion in fiscal year 1994 due to the increase in loan volume. As loan volume increased, the provision for loan defaults and interest subsidies increased. Subsidy Reestimates relate to subsidy costs for loans guaranteed prior to fiscal year 1994. This downward reestimate resulted from higher than anticipated collections of defaulted loans.

III. PROGRAM PERFORMANCE (RESULTS/OUTCOMES)

Since the program's inception, the number of loans made annually has increased from about 89,000 in 1965 to over 6 million in fiscal year 1994; the cumulative loan volume prior to cancellations increased from about $73 million to over $183 billion during this period. Figure 3 documents the change in annual loan volume for the FFEL Program (through September 30, 1993).

Figure 3



Note: Loan volume for FFEL Program (Stafford Subsidized, PLUS, SLS/Stafford Unsubsidized and FISLP) pertains to dollar volume of loan guarantees, some of which are ultimately cancelled. Perkins loan volume refers to actual dollars disbursed. Perkins volume is collected on the basis of an academic (July to June) rather than a fiscal year (October to September). For purposes of this chart academic year 92-93 is equated with fiscal year 93, academic year 91-92 with fiscal year 92, etc.

Prepared by: U. S. Department of Education, OPE/SFAP/PTAS, Analysis and Forecasting Division, Loans Branch

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The FFEL Program has been successful in providing access to postsecondary education for millions of students, but its costs and risks have also increased. Loan defaults increased significantly during the 1980's, but decreased slightly in the past three years. The factors responsible for the increase in defaulted loans were 1) the increase in the FFEL Program loan volume and 2) the changing characteristics of the program population, especially the increase in loans to proprietary school students. Borrowers attending proprietary schools have a higher default rate than those attending other types of postsecondary institutions. Higher default rates are also associated with students who withdraw rather than graduate, have low adjusted gross incomes, and are financially independent, rather than dependent on their parents. However, the decrease in defaults during the past three years is due to legislative changes that reduced the number of high default rate schools that participate in the program.

Accountability Problems

The Department's Office of Inspector General, the Office of Management and Budget, and the General Accounting Office have documented accountability problems that have contributed to defaults, fraud and mismanagement. One of the most significant problems is that the Department's student loan information system contains data that is not timely or accurate, thereby limiting its use for compliance and evaluation purposes. The Congress and the Department, recognizing the need to strengthen program integrity, have made substantial changes to improve the student loan program. For example, on August 10, 1993, the Student Loan Reform Act of 1993 was passed, establishing the Direct Loan Program. In addition, the Department completed phase one of the National Student Loan Data System, which will provide the Department, for the first time ever, with a centralized database containing detailed information on the universe of student loan borrowers. The system will provide on-line access to the data on a loan-by-loan basis. As a result, the Department should be better able to manage the program by ensuring that (1) loan limits are not exceeded, and (2) students who have previously defaulted do not continue to receive loans.

In furthering its "gatekeeping" responsibilities for accreditation, eligibility, and certification, the Department implemented the State Postsecondary Review Program. Since its inception a year ago, the Department has entered into formal agreements with U.S. states and territories to implement the program. Most states are in the process of developing their state review standards in consultation with institutions in their state. The first reviews began in April 1995.

IV. ADDITIONAL INFORMATION

The Department's Office of Postsecondary Education, prepares the Guaranteed Student Loan Programs Data Book annually. This publication, most recently published for fiscal year 1993, is a compilation of statistical data, tables and charts for all components of the FFEL Program since its inception in 1965. It is forwarded to the Congress, the guaranty agencies, and other interested parties upon request.

Fiscal year 1994 was the third year that the FFEL Program financial statements were issued and audited, in accordance with the Chief Financial Officers Act of 1990 and related Office of Management and Budget guidance. Financial data for periods prior to fiscal year 1992, and all statistical data included in this reporting entity overview, are unaudited and based solely on the books and records of the Department of Education.

DIRECT LOAN PROGRAM

The introduction of Direct Loans is at the forefront of initiatives in postsecondary education. It has streamlined the loan process and reduced costs for students, and provided new repayment options, including fixed, graduated, extended, and income-contingent options. In addition, it will save taxpayers an estimated $6.8 billion in the first five years of operations. These improvements will be accomplished through: 1) the reduction of interest subsidies to lenders, and 2) the reduction in payments to guaranty agencies and lenders. A reduction in fees alone is estimated to save students more than $2 billion in the first five years of the program.

During fiscal year 1994, 103 schools participated in the start-up phase of Direct Loans. The schools include a mix of private, public and proprietary institutions operating in 45 states and two U.S. territories. A total of 1,495 institutions have been selected to participate in the program during fiscal year 1995. As one indicator of increased accountability and an improved capacity to manage and monitor its operations, Direct Loans received an unqualified opinion from independent auditors on the fairness of the program's fiscal year 1994 financial statements.

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PRINCIPAL FINANCIAL STATEMENTS

U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
Statements of Financial Position
As of September 30, 1994 and 1993
(Dollars in Thousands)

	1994	1993
ASSETS		
ENTITY ASSETS:		
Intragovernmental Assets:		
Fund Balances with U.S. Treasury	$ 6,846,897	$ 5,298,276
Governmental Assets:		
Credit Program Receivable, Net	1,656,529	817,331
Advances to Guaranty Agencies, Net	39,764	39,767
Accounts Receivable, Other	1,291	875
Total Entity Assets	6,546,481	6,156,249
Total Assets	$ 6,546,481	$ 6,156,249
LIABILITIES AND NET POSITION		
LIABILITIES		
Liabilities Covered By Budgetary Resources:		
Governmental Liabilities:		
Liabilities for Loan Guarantees, Short-Term	$ 4,776,931	$ 2,642,572
Liabilities for Loan Guarantees, Long-Term	3,727,563	3,471,529
Accrued Salaries and Benefits	1,898	2,381
Accrued Other Liabilities	325	0
Total Liabilities Covered by Budgetary Resources	6,506,717	6,116,482
Liabilities Not Covered by Budgetary Resources:		
Intragovernmental Liabilities:		
Borrowing From U.S. Treasury	1,605,315	2,058,407
Governmental Liabilities:		
Liabilities for Loan Guarantees, Short-Term	778,418	3,209,929
Liabilities for Loan Guarantees, Long-Term	5,955,363	5,127,419
Accrued Workers Compensation Liability	957	0
Accrued Salaries and Benefits	1,927	1,897
Total Liabilities Not Covered by Budgetary Resources	8,341,960	10,397,652
Total Liabilities	$ 16,848,697	$ 16,514,134
NET POSITION		
Invested Capital	$ 39,764	$ 39,767
Future Funding Requirements	(8,341,960)	(10,397,652)
Total Net Position	(8,302,216)	(10,357,885)
Total Liabilities and Net Position	$ 6,546,481	$ 6,156,249

The accompanying notes are an integral part of these financial statements

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U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
Statements of Operations and Changes in Net Position
For Fiscal Years Ended September 30, 1994 and 1993
(Dollars in Thousands)

	1994	1993
PROGRAM REVENUES AND EXPENSES		
Program Revenues:		
Interest Earned on Funds Deposited with U.S. Treasury	$ 267,867	$ 172,817
Total Program Revenues	267,867	172,817
Program Expenses:		
Subsidy Expense--Current Year Cohort	3,266,136	2,749,499
Subsidy Reestimates	(1,111,127)	306,523
Interest Expense	439,572	324,522
Salaries & Benefits	26,815	31,861
Travel and Transportation	1,696	0
Rent, Communications, and Utilities	3,826	1,984
Contractual Services	56,397	37,755
Administrative Services	15,232	296
Interagency Agreements	0	426
Printing, Materials, and Supplies	1,103	329
Other Expenses, Net	(14)	13,886
Total Program Expenses	2,719,638	3,469,081
NET OPERATING ACTIVITY -- FFELP	$ (2,431,771)	$ (3,296,264)
Mandatory Administrative Expenses Funded by Direct Loan Appropriations	96,822	0
Operating Activity Funded by FFELP Appropriations	(2,334,949)	(3,296,264)
CHANGES IN NET POSITION		
Net Position, Beginning of Year	(10,357,885)	(12,785,138)
Operating Activity Funded by FFELP Appropriations	(2,334,949)	(3,296,264)
Plus (Minus) Non--Operating Changes:		
Appropriations Received	5,721,805	6,539,777
Appropriations Returned	(1,237,755)	(692,574)
Subsidy Reestimates Returned	(93,432)	(123,686)
Net Position, End of Year	$ (8,302,216)	$ (10,357,885)

The accompanying notes are an integral part of these financial statements

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U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
Statements of Cash Flows
For the Fiscal Years Ended September 30, 1994 and 1993
(Dollars in Thousands)

	1994	1993
CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating Cash Provided:		
Default Claims Principal Collected	$ 833,266	$ 657,962
Default Claims Interest Collected	536,110	354,792
Administrative Charges	0	1,860
Origination Fees	973,104	509,912
Reinsurance Fees	44,761	35,066
Penalty Fees	6,496	40
Other Fees	57,453	8,397
Collections on Advances to Guaranty Agencies	3	1,047
Lender Fees	53,756	0
Sallie Mae Fees	11,976	0
Interest Income, U.S. Treasury	267,867	172,817
Total Operating Cash Provided	2,804,614	1,741,913
Operating Cash Used		
Default Claim Payments	(2,403,571)	(2,474,110)
Death, Disability, and Bankruptcy Payments	(144,846)	(354,144)
Interest Subsidy Payments	(2,062,237)	(1,760,938)
Special Allowance Payments	(144,671)	(106,657)
Closed School Payments	(4,972)	(1,277)
Mandatory Administrative Expenses	(159,890)	(170,774)
Printing & Reproduction	(741)	0
Salaries and Benefits	(23,926)	(28,621)
Travel and Transportation	(1,698)	0
Rent, Communications, & Utilities	(3,826)	(4,238)
Contractual Services	(56,397)	(34,416)
Administrative Services	(14,907)	0
Materials & Supplies	(362)	(314)
Interest to U. S. Treasury	(151,705)	(151,705)
Prompt Payment Act Interest	(3)	0
Other Operating Cash	33	(13,955)
Total Operating Cash Used	(5,193,719)	(5,101,149)
Net Cash Provided (Used) By Operating Activities	(2,388,905)	(3,359,236)
CASH PROVIDED (USED) BY FINANCING ACTIVITIES:		
Appropriated Funds Received	$ 5,721,805	$ 6,539,777
Appropriated Funds Returned	(1,237,755)	(1,750,534)
Subsidy Reestimates Returned	(93,432)	(123,686)
Net Appropriations	4,390,618	4,665,557
Repayments on Loans from U.S. Treasury and the Federal Financing Bank	(453,092)	(31,696)
Net Cash Provided (Used) by Financing Activities	3,937,526	4,633,861
Net Cash Provided (Used) By Operating and Financing Activities	1,548,621	1,274,625
Fund Balances with U.S. Treasury, Beginning of Year	5,298,276	4,023,651
Fund Balances with U.S. Treasury, End of Year	$ 6,846,897	$ 5,298,276

The accompanying notes are an integral part of these financial statements

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U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
Statements of Cash Flows
For the Fiscal Years Ended September 30, 1994 and 1993
(Dollars in Thousands)

	1994	1993
RECONCILIATION OF NET OPERATING ACTIVITY BEFORE APPROPRIATIONS TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Net Operating Activity Funded by FFELP Appropriations	(2,334,949)	(3,296,264)
Adjustments to Reconcile Net Operating Activity to Net Cash Provided (Used) By Operating Activities:		
Decrease (Increase) in Credit Program Receivable, Net	(841,198)	(817,331)
Decrease (Increase) in Accounts Receivable, Net	(416)	14,666
Decrease (Increase) in Advances to Guaranty Agencies, Net	3	1,036
Increase (Decrease) in Liabilities for Loan Guarantees	786,826	736,841
Increase (Decrease) in Accrued Other Liabilities	325	0
Increase (Decrease) in Accrued Salaries & Benefits	(453)	1,816
Increase (Decrease) in Workers Compensation Liability	957	0
Net Adjustments	(53,956)	(62,972)
Net Cash Provided (Used) by Operating Activities	$ (2,388,905)	$ (3,359,236)

The accompanying notes are an integral part of these financial statements

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U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
Statements of Budgatary Resources and Actual Expenses
For the Fiscal Years Ended September 30, 1994 and 1993
(Dollars in Thousands)

	1994	1993
BUDGET		
RESOURCES	$ 6,485,413	$ 7,011,885
OBLIGATIONS		
Direct	$ 5,074,846	$ 5,873,450
Reimbursed	$ 1,410,567	$ 1,138,435
ACTUAL		
Program Expenses	$ 2,719,638	$ 3,469,081
BUDGET RECONCILIATION		
Total Expenses	$ 2,719,638	$ 3,469,081
Add:		
Other Expended Budget Authority	4,088,782	4,089,943
Less: Expenses not covered by Budgetary Resources		
Interest Expense	287,867	172,817
Salaries and Benefits	967	9,816
Unfunded Program expenses	0	362,160
Contractual Services	34,153	2,348
Recoveries of P/Y obligations	590,916	51,359
Accrued Expenditures	5,894,497	6,960,524
Less Reimbursements	1,410,567	1,138,435
Accrued Expenditures, Direct	$ 4,483,930	$ 5,822,089

The accompanying notes are an integral part of these financial statements

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U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

NOTE 1 - REPORTING ENTITY AND MISSION

The Federal Family Education Loan (FFEL) Program (appropriation symbols 91X0230, 91X0231, 9140231 and 91X4251), formerly known as the Guaranteed Student Loan Program, is a program of the United States Department of Education (the Department). The FFEL Program was authorized by the Higher Education Act of 1965 (HEA) as amended, and is designed to increase postsecondary education opportunities for eligible students. As currently authorized, the program operates through state and private nonprofit guaranty agencies to provide insurance and interest supplements on loans made to eligible students attending participating postsecondary schools. The program uses private loan capital, supplied almost exclusively by commercial lenders, but in some instances uses capital supplied by state agencies and schools. Loans disbursed under the program are guaranteed by guaranty agencies and reinsured by the federal government.

There are five FFEL Program components:

(1) Federal Stafford Loans (Subsidized) - Under this component, need-based loans are made to undergraduate and graduate students. The federal government pays the loan interest while the student is in school and during certain grace and deferment periods;

(2) Unsubsidized Federal Stafford Loans - Under this component, loans are made to undergraduate and independent graduate students. These loans do not have interest subsidies for borrowers. The first loans under this component, authorized by the HEA Amendments of 1992 (Public Law 102-325), were guaranteed during fiscal year 1993;

(3) Federal Parent Loans for Undergraduate Students (PLUS) - Under this component, loans are made to parents of dependent students. These loans also do not have interest subsidies for borrowers;

(4) Federal Supplemental Loans to Students (SLS) - Under this component, loans are made to graduate, professional,

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

independent undergraduate, and certain dependent undergraduate students. These loans do not have interest subsidies for borrowers. The SLS program was discontinued on July 1, 1994; and

(5) Federal Consolidated Loans - Under this component, borrowers may have most of their FFEL Program obligations consolidated and their repayment schedules extended. Loans made under the Perkins and Health Professions Student Loan Programs may also be consolidated under this component.

Each component has its own eligibility requirements and loan limits. The majority of loans guaranteed in fiscal years 1994 and 1993 were subsidized Federal Stafford Loans (approximately 64 percent and 70 percent of the dollar amounts guaranteed, respectively). By component, loans for fiscal years 1994 and 1993 were guaranteed as follows:

	1994	
	Number of Loans	Dollar Amount (000s)
Stafford (Subsidized)	4,522,014	$ 14,758,333
Stafford (Unsubsidized)	1,321,783	4,748,445
PLUS	349,815	1,725,980
SLS	553,283	1,868,377
Totals	6,746,895	$ 23,101,135

	1993	
	Number of Loans	Dollar Amount (000s)
Stafford (Subsidized)	4,172,782	$ 12,455,956
Stafford (Unsubsidized)	425,315	1,015,089
PLUS	348,788	1,333,935
SLS	809,815	3,067,092
Totals	5,756,700	$ 17,872,072

The financial statements of the FFEL Program include the accounts of all components of the program. The statements do not include the effects of centrally administered assets and liabilities related to the federal government as a whole, such as property and equipment and borrowing by the U.S. Treasury which may, in part, be attributable to the FFEL Program.

U.S. DEPARTMENT OF EDUCATION
FEDERAL FAMILY EDUCATION LOAN PROGRAM
NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

These principal financial statements have been prepared to report the financial position, results of operations and changes in net position, cash flows, and budgetary resources and actual expenses of the Federal Family Education Loan (FFEL) Program of the U.S. Department of Education, as required by the Chief Financial Officers Act of 1990 (Public Law 101-576). The Department prepared these statements from the books and records of the FFEL Program in accordance with the FFEL Program's accounting policies, which are summarized in this note. These statements are therefore different from the financial reports, also prepared by the Department for the FFEL Program pursuant to the Office of Management and Budget (OMB) directives, which are used to monitor and control the FFEL Program's use of budgetary resources.

The FFEL Program's accounting policies follow an "other comprehensive basis of accounting," comprising the following hierarchy, agreed to by the Comptroller General, the Secretary of the Treasury and the Director of OMB, who are Joint Financial Management Improvement Program (JFMIP) principals:

1. The accounting principles, standards and requirements approved by the three JFMIP principals.

2. Form and content requirements in OMB Bulletin 94-01, Form and Content of Agency Financial Statements, dated November 16, 1993, and subsequent issuances.

3. Accounting standards contained in agency accounting policy, procedures manuals, and/or related guidance as of March 29, 1991, so long as they are prevalent practices.

4. Accounting Principles published by authoritative standard setting bodies and other authoritative sources: (1) in the absence of other guidance in the first three parts of this hierarchy, and (2) if the use of such accounting standards improves the meaningfulness of the financial statements.

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U.S. DEPARTMENT OF EDUCATION
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SEPTEMBER 30, 1994 AND 1993

OMB approved the following deviation from OMB Bulletin 94-01 in the FFEL Program's principal financial statements:

> The Statements of Operations and Changes in Net Position follow the format suggested in the Governmental Accounting Standards Board's Codification of Governmental Accounting and Financial Reporting Standards, which identifies a separate disclosure for the total effects of operations, exclusive of appropriations or intra-governmental funding sources.

B. Basis of Accounting

Transactions are recorded on an accrual accounting basis and a budgetary basis. Under the accrual basis, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and control over the use of federal funds. Differences between the accrual basis recognition of expenses and the budgetary basis recognition of direct accrued expenditures are presented in the Statements of Budgetary Resources and Actual Expenses. For purposes of these statements, obligations represent liabilities, primarily for loan guarantees, that will require payments from previous, current, or future period appropriations. Reimbursements include sums received for origination fees, reinsurance fees, lender fees, collections on defaulted loans, and certain transfers from the Financing Account.

C. Budgets and Budgetary Accounting

The FFEL Program is an entitlement program and the Department is authorized to incur obligations as necessary for mandatory program costs such as payments for interest subsidies and defaulted loans. This authority is based on the Higher Education Act, as amended. There is no limit on the volume of loans guaranteed. However, the costs of federal administration of the FFEL Program are discretionary, and the authority to incur obligations for these costs is limited by annual appropriation acts.

The Federal Credit Rsform Act of 1990 (CRA) was enacted to more accurately measure the costs of federal credit programs, place the

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FEDERAL FAMILY EDUCATION LOAN PROGRAM
NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

cost of credit programs on a budgetary basis equivalent to other federal spending, encourage the delivery of benefits in the form most appropriate to the needs of the beneficiaries, and improve the allocation of resources among and between credit programs and other spending programs. The FFEL Program, as a credit program within the Department, was required to conform with the provisions of CRA beginning with fiscal year 1992.

Due to enactment of CRA, there are two budget accounts for the FFEL Program activities: (1) a Liquidating Account to record all cash flows to and from the program resulting from loan guarantee commitments made prior to fiscal year 1992; and (2) a Program Account to record subsidy costs associated with loan guarantee commitments made during fiscal year 1992 and beyond, as well as administrative expenses of the program. Administrative expenses include discretionary expenses for salaries, expenses and overhead directly related to the program. Administrative expenses also include mandatory expenses such as administrative cost allowancer, supplemental preclaims assistance payments and contract collection costs. For loans made prior to 1993, these mandatory expenses are separately identified on a cash basis. However, beginning with the 1993 cohort, mandatory administrative expenses are included in the FFEL estimate of subsidy costs of each year's cohort. (A cohort is a group of loan guarantees committed by the program in the same fiscal year.) The subsidy costs are estimated on a net present value basis and the Program Account receives appropriations for these costs. In addition to the budgetary accounts, the FFEL Program has a non-budgetary account called the Financing Account, which records all cash flows resulting from loan guarantee commitments made during and after fiscal year 1992. The cash flows include the subsidy costs from the Program Account, interest earned on uninvested funds, and defaulted loan collections. The Statements of Budgetary Resources and Actual Expenses reflect the transactions of the Program and Liquidating Accounts only.

D. Financing Sources and Program Revenues

The FFEL Program receives the majority of the funding needed to support the program through appropriations. The FFEL Program is funded primarily by two appropriations: (1) an appropriation for its

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SEPTEMBER 30, 1994 AND 1993

Liquidating Account (appropriation symbol 91X0230), and (2) an appropriation for its Program Account (appropriation symbols 91X0231 and 9140231). In addition to appropriations, under CRA the FFEL Program receives interest income on uninvested funds in the Financing Account.

E. Fund Balances With U.S. Treasury

The FFEL Program does not maintain cash in commercial bank accounts. Cash receipts and disbursements are processed by the U.S. Treasury. The Fund Balances with U.S. Treasury are primarily appropriated funds that are available to pay current liabilities and finance subsidy expenses for post-1991 loans.

F. Credit Program Receivables

Credit program receivables consist of the gross amounts paid to guaranty agencies for defaulted loans, net of allowances for subsidy cost. The allowance for subsidy cost is the estimated uncollectible amount and is based on historical delinquency rates.

G. Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid by the FFEL Program as the result of a transaction or event that has already occurred. However, no liability can be paid by the FFEL Program absent an appropriation. Liabilities for which an appropriation has not been enacted are therefore classified as liabilities not covered by budgetary resources. The majority of the FFEL Program's liabilities are considered entitlements and therefore the program is required to pay these liabilities if all eligibility requirements are met. Any non-entitlement liabilities of the FFEL Program, such as federal administrative costs, not arising from contracts, and entitlements not yet vested, can be abrogated by the government acting in its sovereign capacity.

The FFEL Program loan guarantees are recorded in accordance with CRA and Statement of Federal Financial Accounting Standards Board (FASAB) Statement Number 2, Accounting for Direct Loans and Loan

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Guarantees. CRA and FASAB require the recording of the net present value of subsidy costs (i.e., estimated interest rate differentials, interest subsidies, defaults, collection on defaulted loans, fee offsets, mandatory administrative expenses, and other cash flows) associated with loan guarantees to be recognized in the year loans are made for both budgetary and accounting purposes. In addition, the net present value of these subsidy costs are recorded as liabilities for loan guarantees. As payments for defaulted loans are made, the gross amount paid to guaranty agencies is removed from the liability account and recorded as credit program receivables.

In addition, a distinction is made between short-term and long-term liabilities. A short-term liability is anticipated to be paid within one year, whereas a long-term liability is anticipated to be paid beyond one year of the Statement of Financial Position date.

H. Subsidy Reestimates

OMB guidance requires that the subsidy cost of each cohort of guaranteed loans be reestimated at the beginning of each fiscal year following the year in which the initial disbursement was made, as long as the loans are outstanding. Any increases (or decreases) in the subsidy cost resulting from these reestimates are recognized as an increase (or reduction) in subsidy expenses in the current period. In addition, for an increase in subsidy cost, the Department will request additional funding and an outlay will be made from the Program Account to the Financing Account. For a decrease in subsidy cost, an outlay will be made from the Financing Account to a special fund receipt account established for the program. The receipts in the special fund receipt account are earmarked for the FFEL Program and are available by appropriation for the subsidy cost of new guaranteed loans or subsequent higher cohort reestimates.

I. Annual, Sick, and Other Leave

Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as taken.

J. Retirement Plan

FFEL Program employees participate in one of two retirement plans. The first plan is the Civil Service Retirement System (CSRS), to which the FFEL Program makes matching contributions equal to seven percent of pay. The second plan, the Federal Employees Retirement System (FERS), became effective on January 1, 1987, pursuant to Public Law 99-335. Employees hired prior to January 1, 1984, can elect to join either FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to FFEL Program employees, which automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. In addition, for employees covered under FERS, the FFEL Program also contributes the employer's matching share for Social Security. The FFEL Program does not report CSRS or FERS assets, accumulated plan benefits, or liabilities not covered by budgetery resources, if any, applicable to its employees. Reporting such amounts is the responsibility of the U.S. Office of Personnel Management.

K. Reclassification

Certain 1993 amounts have been reclassified to conform to 1994 classifications.

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FEDERAL FAMILY EDUCATION LOAN PRC ``AM
NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

NOTE 3 - FUND BALANCES WITH U.S. TREASURY

The FFEL Program's fund balances with the U.S. Treasury were as follows (in thousands):

	1994		
	Obligated	Unobligated	Total
Appropriated Funds	$ 1,463,241	$ 49	$ 1,463,290
Revolving Funds	336,592	5,047,015	5,383,607
Total	$ 1,799,833	$ 5,047,064	$ 6,846,897

	1993		
	Obligated	Unobligated	Total
Appropriated Funds	$ 1,710,739	$ -0--	$ 1,710,739
Revolving Funds	422,729	3,164,808	3,587,537
Total	$ 2,133,468	$ 3,164,808	$ 5,298,276

NOTE 4 - LOAN GUARANTEES

An analysis of credit program receivables, liabilities for loan guarantees, and the nature and amount of the subsidy costs associated with the loan guarantees are provided in the following sections.

A. Credit Program Receivables

Credit program receivables as of September 30, 1994 and 1993, were (in thousands):

	1994	1993
Loans Receivable	$ 19,366,541	$ 17,151,672
Interest Receivable	605,505	1,414,869
Total Loans and Interest Receivable	$ 19,972,046	$ 18,566,541
Allowance for Subsidy Cost	(18,313,517)	(17,749,210)
Net Credit Program Receivables	$ 1,658,529	$ 817,331

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SEPTEMBER 30, 1994 AND 1993

B. Liabilities for Loan Guarantees

A distinction is made in the FFEL Program's principal financial statements between liabilities covered by budgetary resources and liabilities not covered by budgetary resources. The estimated costs of loan guarantees for pre-1992 loans are reported primarily as liabilities not covered by budgetary resources. The liabilities for loan guarantees at September 30, 1994 and 1993 were (in thousands):

	1994		
	Pre-1992 Loans	Post-1991 Loans	Total
SHORT-TERM LIABILITIES			
Liabilities Covered by Budgetary Resources	$ 1,518,138	$ 3,258,793	$ 4,776,931
Liabilities Not Covered by Budgetary Resources	778,418	-0-	778,418
Total Short-Term Liabilities	$ 2,296,556	$ 3,258,793	$ 5,555,349
LONG-TERM LIABILITIES			
Liabilities Covered by Budgetary Resources	$ -0-	$ 3,727,563	$ 3,727,563
Liabilities Not Covered by Budgetary Resources	3,555,067	2,400,296	5,955,363
Total Long-Term Liabilities	$ 3,555,067	$ 6,127,859	$ 9,682,926
Total Liabilities	$ 5,851,623	$ 9,386,652	$ 15,238,275

	1993		
	Pre-1992 Loans	Post-1991 Loans	Total
SHORT-TERM LIABILITIES			
Liabilities Covered by Budgetary Resources	$ 957,882	$ 1,684,690	$ 2,642,572
Liabilities Not Covered by Budgetary Resources	3,209,929	-0-	3,209,929
Total Short-Term Liabilities	$ 4,167,811	$ 1,684,690	$ 5,852,501
LONG-TERM LIABILITIES			
Liabilities Covered by Budgetary Resources	$ -0-	$ 3,471,529	$ 3,471,529
Liabilities Not Covered by Budgetary Resources	4,327,453	799,966	5,127,419
Total Long-Term Liabilities	$ 4,327,453	$ 4,271,495	$ 8,598,948
Total Liabilities	$ 8,495,264	$ 5,956,185	$ 14,451,449

The Department estimates that the outstanding balance of guaranteed loans was $77 billion and $69 billion at September 30, 1994 and 1993, respectively.

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS
SEPTEMBER 30, 1994 AND 1993

C. Subsidy Expenses

Subsidy expenses for the FFEL program incurred in fiscal years 1994 and 1993 were (in thousands):

	1994	1993
CURRENT YEAR'S ESTIMATE		
Provision for Loan Defaults (Net)	$ 1,856,985	$ 1,452,945
Provision for Interest Rate Subsidies (Net)	1,259,694	1,047,509
Mandatory Administrative Expense	169,457	249,045
Subtotal, Current Year's Estimate	$ 3,286,136	$ 2,749,499
REESTIMATES		
Fiscal Year 1993 Loans	$ 849,270	$ -0-
Fiscal Year 1992 Loans	(96,336)	104,025
Pre-1992 Loa.	(1,864,061)	204,498
Subtotal, Reestimates	$ (1,111,127)	$ 308,523
Total Subsidy Expense	$ 2,175,009	$ 3,058,022

NOTE 5 - ADVANCES TO GUARANTY AGENCIES

Advances to guaranty agencies represent amounts advanced to guaranty agencies under sections 422(a) and 422(c) of the HEA for commencement of agency operations and making loan default payments to lenders. The balances as of September 30, 1994 and 1993, were (in thousands):

	1994	1993
Advances to Guaranty Agencies	$40,165	$40,168
Allowance for Doubtful Accounts	(401)	(401)
Advances to Guaranty Agencies, Net	$39,764	$39,767

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS
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NOTE 6 - BORROWING FROM U.S. TREASURY

On September 30, 1992, the FFEL Program borrowed $2.09 billion from the U.S. Treasury in accordance with OMB instructions under CRA on accounting for noncontractual modifications made to its loan guarantees. The noncontractual modifications were:

- The Emergency Unemployment Compensation Act of 1991 - authorized the Department to continue collecting on defaulted loans through the Internal Revenue Service (offsetting income tax refunds); such authority was originally due to expire in fiscal year 1994. The Act also authorized the use of wage garnishment as a collection tool for defaulted loans.

- The Higher Education Amendments of 1992 - eliminated the statute of limitations on collections activities for certain student loans.

The FFEL Program will repay the borrowing, at an annual interest rate of 7.37 percent, with increased collections on defaulted loans resulting from the noncontractual modifications. During fiscal year 1994, the FFEL Program used collections to reduce the balance of its U.S. Treasury debt as follows (in thousands):

Borrowing from U.S. Treasury, Balance 9/30/93	$ 2,058,407
Payment on Outstanding Balance, 1994	(453,092)
Borrowing from U.S. Treasury, Balance 9/30/94	$ 1,605,315

The aggregate maturities of this debt, based on estimated collections on defaulted loans, for the years subsequent to September 30, 1994, are as follows (in thousands):

1995	$ 471,137
1996	453,956
1997	326,149
1998	237,302
1999	116,771
Total	$ 1,605,315

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS
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NOTE 7 - NET POSITION

The FFEL Program's Net Position, at September 30, 1994 and 1993, included:

Invested Capital - These are amounts advanced to guaranty agencies under sections 422(a) and 422(c) of the HEA for commencement of agency operations and making loan default payments to lenders; and

Future Funding Requirements - This represents the net amount of financial resources that will be required in the future to liquidate liabilities not covered by available budgetary resources.

NOTE 8 - INTEREST EXPENSE

Interest expense is comprised of the payment of interest on subsidy (uninvested funds) and the interest accrued on borrowing from the U.S. Treasury disclosed in Note 6. For fiscal years 1994 and 1993, interest expense was (in thousands):

		1994	1993
Payment of Interest on Subsidy	FY92	$ 132,252	$ 137,524
	FY93	117,152	35,293
	FY94	38,463	-0-
		$ 287,867	$ 172,817
Interest on Borrowing from U.S. Treasury		$ 151,705	$ 151,705
Total Interest Expense		$ 439,572	$ 324,522

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NOTE 9 - OTHER EXPENSES, NET

Expenses recorded as "Other Expenses, Net" consist primarily of the additional costs for current loans resulting from the Higher Education Amendments of 1992. These costs include guaranty agency cash reserve repayments as follows (in thousands):

	1994	1993
Guaranty Agency Cash Reserve Repayments	$ -0-	$13,954
Other	(14)	(68)
Total	$ (14)	$13,886

NOTE 10 - GUARANTY AGENCIES' ADMINISTRATIVE COSTS

Prior to October 1, 1993, the FFEL Program paid an administrative cost allowance (ACA) equal to one percent of new loan volume to all guaranty agencies. In accordance with the Omnibus Budget Reconciliation Act of 1993, which includes the Student Loan Reform Act of 1993, the FFEL Program ACA was replaced by an administrative expense allowance (AEA) which is funded by both the FFEL Program and the William D. Ford Federal Direct Loan Program (Direct Loan Program). Of the $281.6 million of mandatory administretive expenses during fiscal year 1994, $96.8 million was funded by the Direct Loan Program appropriations.

NOTE 11 - APPROPRIATED FUNDS RECEIVED AND RETURNED

The FFEL Program draws on appropriated funds for the Liquidating Account to pay the costs of pre-1992 loans, and for the Program Account to pay ths costs of post-1991 loans. Appropriated funds received for the Liquidating Account and Program Account were (in thousands):

	1994	1993
Liquidating Account	$ 2,718,807	$ 3,767,211
Program Account	3,002,998	2,772,566
Total	$ 5,721,805	$ 6,539,777

The fiscal years 1994 and 1993 mid-session reviews of the FFEL Program's subsidy costs determined that funds drawn from the

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Liquidating Account's and Program Account's appropriations would not be needed during the fiscal years. Appropriated funds returned to the U.S. Treasury for the Liquidating Account and Program Account were (in thousands):

	1994	1993
Liquidating Account	$ 768,273	$ 682,107
Program Account	469,482	10,467
Total	$ 1,237,755	$ 692,574

Included in the Program Account's fiscal year 1993 appropriated funds returned was $2 million that the appropriation legislation earmarked for two commissions which were not subsequently established, the Commission on the Cost of Higher Education and the National Commission on Independent Higher Education.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

Guaranty Agency Advances and Reserve Funds

Cumulative outstanding loan guarantees were approximately $77 billion at September 30, 1994. These loans are guaranteed by 45 guaranty agencies, operating in a total of 54 states and territories. Prior to 1965, guaranty agencies existed in 17 states. The Higher Education Act of 1965 provided that advances be made in the form of "seed money" to existing guaranty agencies and for assisting in the formation of guaranty agencies in all states. As of September 30, 1994, there was $40.2 million outstanding in advances to guaranty agencies (also see Note 5, Advances to Guaranty Agencies).

The aggregate balance of reserves at the guaranty agencies was $1.6 billion as of September 30, 1994 and $1.7 billion as of September 30, 1993. Reserves are comprised of federal reinsurance payments, insurance premiums, collections on defaulted loans (agencies are allowed to keep approximately 27 percent of all funds collected to cover collection costs), investment income, administrative cost allowances/administrative expense allowance and federal advances. Disbursements from reserves are allowed for lender claims, operating expenses, and reinsurance fees, and for remitting to the

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Department its share (73 percent) of collections on defaulted loans.

The Omnibus Budget Reconciliation Act of 1993 and the Student Loan Reform Act of 1993 authorized the Department, as it deems appropriate, to recover excess reserves. These reserves are not reported in the financial statements of the FFEL Program since the Department's recovery of these amounts is contingent on the Secretary's determination that such recovery would be appropriate.

Financial Difficulties of Guaranty Agencies

On October 31, 1990, the Department entered into agreements with the Student Loan Marketing Association (SLMA, also known as Sallie Mae) to wind down the operations of the Higher Education Assistance Foundation (HEAF), the largest guaranty agency participating in the FFEL Program at that time. HEAF was essentially financially insolvent and was unable to pay lenders' default claims. Under the agreements, SLMA agreed to manage HEAF's wind down over a three-year period ending on December 31, 1993. SLMA was responsible for disbanding HEAF and distributing its outstanding guarantees to other guaranty agencies. The Department allowed HEAF to retain the full amount of collections on defaulted loans during the three-year period and agreed to pay HEAF 100 percent reinsurance without regard to default rate. The majority of HEAF's net cash assets, which amounted to $300 million (minus a reserve fund to pay contingent liabilities), was returned to the Department on March 31, 1994. A deposit fund account entitled "HEAF Claims Reserves" was established to hold the assets until no longer required to meet claims against HEAF. At that time, the funds will be treated as a collection in the Liquidating Account. In addition, HEAF has established a reserve fund of $34.7 million to provide for any successfully asserted lawsuits against HEAF in the future.

Loan guarantees not distributed to other guaranty agencies as of December 31, 1993, are being managed by SLMA. SLMA is responsible for all costs associated with managing this portfolio except for default claims. The Department will continue to pay the applicable reinsurance for default claims on these guarantees. These defaults will immediately be assigned to the Department for

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collection. The net cost of loan defaults guaranteed by HEAF is included in the FFEL Program's liabilities for loan guarantees.

SLMA Debt Obligations

The Higher Education Act of 1965, as amended, authorized the Department to guarantee payment of principal and interest on certain SLMA debt obligations issued by the U.S. Treasury prior to October 1, 1984. It also provided the Department with borrowing authority and further authorized appropriations, as necessary, for repayment of funds borrowed in discharging the guarantee obligation. SLMA is a shareholder-owned corporation chartered by Congress in the Education Amendments of 1972 (Public Law 92-318) to expand funds available for student loans by purchasing student loans and thus providing liquidity to lenders originating such loans. SLMA's borrowed amounts were consolidated into one loan of $5 billion in 1982. Loan principal payments of $30 million were made on an annual basis with a $4.3 billion balloon payment due in 1996 and a final $400 million payment in 1997. The floating rate notes bore interest at 0.125 percentage points above the average rate of the weekly 91-day Treasury bill auctions. The outstanding principal balance of SLMA's debt obligation at September 30, 1993 was $4.79 billion. During fiscal year 1994, SLMA repaid the total outstanding balance.

Borrower Class Actions

The Department is involved in pending litigation challenging the enforceability of FFEL Program loans made to students who attended various trade schools that have closed. In most instances, a large percentage of the loans in question are in default and have been acquired by guaranty agencies and reimbursed by the Department. Thus, the Department has already incurred losses from payment of defaults. No provision has been made in the principal financial statements for any potential reductions in estimated future collections related to the outcome of these suits, since the Department's potential loss exposure is uncertain and cannot be estimated with sufficient reliability.

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The William D. Ford Federal Direct Loan Program

On August 10, 1993, President Clinton signed the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66). A portion of that Act entitled "The Student Loan Reform Act of 1993" requires the phase-in of federal direct student lending. Direct student lending, as a percentage of new student loan volume, will be phased in over five years as follows:

Academic Year	Percent
1994-95	5%
1995-96	40%
1996-97	at least 50%
1997-98	at least 50%
1998-99	at least 60%

The Student Loan Reform Act of 1993 ensures adequate financing for the current guaranty agencies during the transition and provides for alternative mechanisms to assure loan guarantees in the event that any of the guaranty agencies do not continue to operate. The Transitional Guaranty Agency, Inc. was formed to provide for the continuing operation of the FFEL Program during all periods of time when both the FFEL and Direct Loan Programs are in parallel operation, and also to serve as a guarantor of last resort. The implementation plans for the Direct Loan Program provide for the Department's cost of transitioning outstanding guaranteed loans, therefore no provision for such cost has been included in the FFEL Program's principal financial statements.

Other Matters

The Department is involved in various other claims and legal actions related to the FFEL Program arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the financial statements of the FFEL Program.

APPENDIX I

STATUS OF PRIOR YEARS'

FINANCIAL AUDIT RECOMMENDATIONS

STATUS OF PRIOR YEARS' FINANCIAL AUDIT RECOMMENDATIONS

We determined the status of the following recommendations based on our audit work at Education during fiscal year 1994 and on our discussions with Education officials. However, we have not fully assessed the appropriateness or effectiveness of all of the responses identified in the following table.

Report/Recommendations	Action complete	Action in progress	Action planned	No specific action planned
Financial Audit: Federal Family Education Loan Program's Financial Statements for Fiscal Years 1993 and 1992 (GAO/AIMD-94-131; ACN 17-[illegible], June 1994)				
The Secretary of Education direct the Assistant Secretary for Postsecondary Education to perform periodic analyses to determine whether lenders are submitting billing reports promptly, within 90 days after the end of the quarter. These analyses should include follow up procedures with individual lenders not submitting billing reports promptly.		X		
Secretary of Education direct the Assistant Secretary for Human Resources and Administration to clearly identify security responsibilities and oversight for Education's general ledger system, including establishing a security officer having responsibilities for the overall security of the system.			X	
The Assistant Secretary for Human Resources Administration should provide security training for security personnel and supporting technical staff who are responsible for the general ledger system.			X	
Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, March 16, 1993)				
Congress amend the Higher Education Act to require that originating lenders pay loan origination fees even if the loan is subsequently sold to another lender.				X
Require that guaranty agencies and lenders annually provide Education an independent public accountant's positive attestation on the claims for payment submitted to the federal government, and the basis for such attestation, including an opinion on the adequacy of internal controls over such claims		X		
Test billings from guaranty agencies and lenders as part of its internal reviews.		X		
Require staff to follow up on questioned costs and other amounts owed based on reviews of guaranty agencies and lenders within a designated period of time from the time findings are reported.		X		
Study the feasibility of requiring guaranty agencies to standardize their FFELP loan accounting systems.				X*

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REPORT/RECOMMENDATIONS	Action complete	Action in progress	Action planned	No specific action planned
Reassess and, if appropriate, adjust the NSLDS implementation date after completion of a detailed system design.	X			
Develop written procedures detailing the methodology to be used to derive the financial statement estimate of loan guarantee subsidies and require that each year's estimate be fully documented and approved by the Department's CFO office.	X			
Establish and maintain subsidiary ledgers for the FFELP.		X		
Develop procedures to ensure that the general ledger is periodically reconciled to subsidiary records maintained by OPE.		X		
Establish an acceptance testing group responsible for independently testing FFELP application system changes prior to implementation.	X			
Implement controls described in the Department's ADP Technical Controls Handbook to ensure that all data received from guaranty agencies and lenders is consistent and accurate.	X			
Implement procedures to ensure that internal control reviews and risk assessments of the FFELP information systems are performed periodically as required by OMB Circulars A-123 Internal Control Systems, A-127, Financial Management Systems, and A-106, Management of Federal Information Resources.	X			
Enhance the existing computer disaster recovery plan to include contingency options at Education headquarters and regional offices regarding key original documents.	X			
Require that the security administrator and appropriate supporting technical staff have formal training in the specific operating systems and access control software used by the FFELP contractor.	X			
Develop a comprehensive plan for revising the role of guaranty agencies and the manner in which they are compensated.		X		
Financial Management: Education's Student Loan Programs Controls Over Lenders Need Improvement (GAO/AIMD-93-33, September 9, 1993).				
Develop a comprehensive strategy for determining the accuracy of information reported on lender's quarterly billings.		X		
Monitor and follow up with lenders whose quarterly billings fail to meet Education's internal automated edit checks reasonability tests.		X		
Develop and implement procedures for converting major automated systems, including a requirement that parallel systems be run for an appropriate period of time, to ensure that new systems are properly processing program data.	X			

*The Federal Direct Student Loan Program, which was established in 1993, will revise the role of guaranty agencies since FFELP is expected to significantly phase down over the next 5 years.

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APPENDIX II

DEPARTMENT'S COMMENTS

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OIG'S RESPONSE

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UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

May 23, 1995

Steven A. McNamara
Assistant Inspector General for Audits
U.S. Department of Education
Washington, DC 20202

Dear Mr. McNamara:

This is in response to your request for comments on the draft audit report on the financial statements of the Federal Family Education Loan Program (FFEL Program) for the fiscal year ended September 30, 1994.

Thank you for the opportunity to comment on the report. We appreciate the efforts of your staff in furthering our goal to improve student loan program management and accountability. As noted, the Department has worked hard to improve the management of the program and plans to continue this effort.

The Department is continuing actions to more effectively manage the FFEL Program by recruiting and training the highest quality of program and financial managers; developing new systems, such as the National Student Loan Data System (NSLDS) and a new centralized accounting system; improving gatekeeping functions; focusing greater attention on guaranty agency oversight; actively pursuing legislative changes to reform the student loan program; and transitioning from guaranteed lending to direct lending.

In response to comments in the report that unreliable loan data prevents the Department from reasonably estimating costs, we disagree with your conclusion. We feel strongly that the estimates of liabilities for loan guarantees and subsidy expenses are reasonable. For three consecutive years, these liabilities and expenses were consistent with cash flow information that was found to be reliable. While there are internal control weaknesses inherent in the program structure, this alone does not prevent determination of reliable liability estimates for financial statement presentation. Original estimates (of which the major portion was projected during September 1991) as compared to actual cash flows show small variances and were consistently conservative. Also, the correlation between estimated liabilities and cash flows is very clear. The amounts paid for default claims and interest subsidies after the end of each fiscal year consistently provide evidence that reported year-end liabilities exist and are reasonably estimated.

The Department reestimates its liabilities for loan guarantees each year, adjusting for changes in interest rates, default rates, current legislation and other factors. These

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estimates use projections from the liability model referred to in the report as an initial source of information, from which we perform extensive financial analyses to determine a reasonable estimated liability. In addition, despite inaccuracies in some of the data received from program participants, the overall risk of understating or overstating liabilities and expenses is low for the following reasons:

(1) Data received from guaranty agencies was used primarily to determine loan default and collection relationships and trends, rather than absolute amounts;

(2) Fiscal year 1992 through 1994 statements of cash flows were found to be reliable, indicating that the Department accurately reports the amount of payments made for default claims and interest subsidies;

(3) Most lenders and guaranty agencies make timely and complete claims for defaulted loans and interest subsidies in order to be reimbursed promptly; and

(4) Reviews performed in prior years by the General Accounting Office and an independent public accounting firm at guaranty agencies and lenders did not identify material overpayments.

Additionally, factors that should assist us in analyzing and determining liability estimates and reduce the level of liabilities for loan guarantees and subsidy expenses in the future are:

(1) NSLDS, now being implemented, will improve the quality of student loan data and facilitate timely analyses of detailed information on collections, defaults, and other data used to estimate liabilities;

(2) Student loan defaults are declining, primarily due to legislation requiring the Department to discontinue guarantying loans to students attending schools with excessive cohort default rates;

(3) Direct Loan Program competition has encouraged guaranty agencies and lenders to manage the FFEL Program more efficiently; and

(4) Collections on defaulted loans are improving due to legislative changes, including elimination of the statute of limitations on active collections, continuation of Internal Revenue Service offsets, and wage garnishments of defaulted borrowers.

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With respect to the recommendations in the report, we are in general agreement. However, before developing a comprehensive corrective action plan, we need to further analyze the specific recommendations to determine the best way to proceed toward achieving the desired results. We plan to do so promptly and take all appropriate corrective actions.

The Department is committed to continuing cooperative efforts to improve student loan program management and to better serve program participants and the taxpayers. If you have any questions, please contact Linda Paulsen, Office of Postsecondary Education at (202) 708-4664 or Gloria Jarmon, Office of the Chief Financial Officer at (202) 401-0561.

Sincerely yours,

Donald R. Wurtz
Chief Financial Officer

David A. Longanecker
Assistant Secretary for
Postsecondary Education

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OIG RESPONSE

In response to the Department's comments that the estimates of liabilities for loan guarantees and subsidy expenses are reasonable, we believe that at this time there is insufficient reliable audit evidence to support this conclusion. We have concluded this for the following reasons:

- The liabilities for loan guarantees and subsidy expenses are the most material and significant balances on the financial statements. The amount of these liabilities in the Department's financial statements for 1994 is equal to 178% of total assets and 90% of total liabilities. Likewise, the subsidy expense reported is equal to 80% of program expenses and 89% of net operating activity. Such significant balances require more audit evidence than less material amounts.

- The FFELP's liabilities for loan guarantees were primarily calculated using an OPE model for pre-92 loan guarantees and a Budget Services model for post-91 loan guarantees. Prior GAO and OIG audits reported that calculations of liabilities using OPE's model cannot be considered reliable because the model is based upon unreliable data. The model remains essentially unchanged. Budget Services' model relies substantially upon the same trends and assumptions as OPE's.

- Revisions by OCFO to OPE's projections are limited to reducing the collection rate from 90%, allocating collections between principal and interest, and estimating some other miscellaneous fees and costs. These adjustments do not address the impact of the underlying unreliable data on the models' projections.

- As stated in our report, we believe the comparison of model projections to actual cash flows has merit. We do not believe, however, that three years of actual cash activity is sufficient to support the reasonableness of a cohort's cash flows which occur, according to Department projections, over a period in excess of 10 years. An analytical test of this type is insufficient as the virtual sole support for balances as material as the liabilities and the related subsidy expenses.

- We agree there should be a direct correlation between a reasonable estimate of liabilities and cash flows. This assumed correlation is weakened, however, by the Department's lack of controls to ensure accurate payments are made for defaults, interest subsidies, and special allowances. Without such controls, we have less comfort that recent volumes of actual cash flows are representative of future trends.

We agree with management's statement that internal control weaknesses alone do not prevent determination of reliable estimates for financial statement purposes. Therefore, we emphasize that our disclaimer is based upon the lack of sufficient reliable data and not on internal control weaknesses that may have contributed to the lack of reliable data.

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